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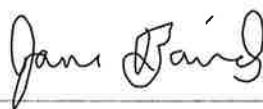
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Preventing Fraud in the Workplace by Creating an Ethical Environment

Senior Project

In partial fulfillment of the requirements for
The Esther G. Maynor Honors College
University of North Carolina at Pembroke

By

Daniel Leonard
Accounting
May 1st, 2019

A handwritten signature in cursive script, appearing to read "Daniel Leonard", written over a horizontal line.

Daniel Leonard
Honors College Scholar

A handwritten date "May 1, 2019" written in cursive script over a horizontal line.

Date

A handwritten signature in cursive script, appearing to read "Jane Baird", written over a horizontal line.

Dr. Jane Baird
Faculty Mentor

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Date

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Abstract

Fraud in the world today is much more prevalent than most people believe. Fraudulent activity costs billions of dollars in the U.S. alone each year, and has other damaging impacts to the companies involved. Thankfully, the risks of fraud can be significantly reduced with the use of a quality system of internal controls. These are systems and policies that companies put into place that limit the opportunity of a fraudster to commit a fraudulent act. There are many methods to creating an internal control system, but the most effective way is through the use of creating an ethical environment in the workplace. If done properly, this ethical environment, in tandem with standard policies of internal controls, essentially dismantles the reason that fraudulent acts occurs, thus lowering the risk of fraud to a much more acceptable level. If the extremely high quantitative and qualitative costs of fraud are to be kept to a minimum, companies need to begin to create a work environment in which their employees can thrive and get the most out of their jobs.

Preventing Fraud in the Workplace by Creating an Ethical Environment

I FRAUD IN THE WORKPLACE

Each year around the world, malicious individuals and groups commit fraudulent acts that cost billions of dollars to the companies that they harm, as well as damage the reputation of that company going forward. These types of fraudulent acts come in many different forms, but all stem from the same three factors that come together to make the fraud triangle; pressure, opportunity and rationalization.

A) Types of Fraudulent Activity

To fully grasp the magnitude of the fraud problem, you must first understand that the term fraud encompasses many different acts. There are essentially three overarching types of fraud that encompass more specific fraudulent acts. The three types are corruption, asset misappropriation, and fraudulent financial reporting (Raftery and Holder, 2017).

1) Corruption

Corruption is one of the more common forms of fraud. It includes acts such as bribery and creating conflicts of interest. Fraud cases involving corruption have shown that they are most likely to be committed by management and individuals who have some type of authority within a company (Association of Certified Fraud Examiners, 2018)

2) Asset Misappropriation

Asset misappropriation remains the most common of fraudulent acts globally, with around 89% of cases involving some form of asset misappropriation. This category of fraud includes acts such as embezzlement or other illegal diversions of company assets. The median loss for these acts in 2018 was around \$114,000 globally (Association of Certified Fraud Examiners, 2018).

3) Fraudulent Financial Reporting

When a company misrepresents the numbers in their financial statements, this is called fraudulent financial reporting. While this is the least common of the categories of fraud, it is oftentimes the most costly, with the median loss being around \$800,000 globally in 2018 (Association of Certified Fraud Examiners, 2018). This is because so many investors and creditors rely on the accuracy of financial reports in order to make sound financial decisions with their money. If this information is falsified, such as a company reporting much healthier revenues and assets on their books than what is actually occurring, the investors and creditors will be severely harmed financially when fraud gives way to the truth and the company falls through.

B) The Fraud Triangle

As mentioned previously, the fraud triangle is the root cause of people's actions when committing a fraudulent activity. Each side of the triangle is a separate factor that is occurring in the workplace, and when all three parts are present, the risk of fraud is very high.

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1) Pressure

The first part of the fraud triangle is pressure, which are the various forces that provide the motivation to commit a fraudulent act. These are positive factors, such as a bonus based on performance which leads management to falsify their numbers, or negative factors, such as an employee stealing cash because they came under intense personal financial hardship. Without these pressures in the workplace, there is much less incentive to commit fraud (Dorminey; Flemming; Kranacher, 2012).

2) Opportunity

The second part of the fraud triangle is opportunity. This is when an individual or group is in a position in which they can perpetrate fraud and subsequently cover their tracks. This usually occurs when an employee or manager has been given too much trust or too many responsibilities, and can take advantage of their position to commit some type of fraudulent act. Without opportunity, it becomes much more difficult for individuals to perpetrate fraud (Dorminey et al., 2012).

3) Rationalization

The final part of the fraud triangle is rationalization, which is the act of justifying one's actions using logic, even if that logic is not necessarily appropriate. This can come in many different forms, and can include telling yourself things like, "I've earned this" or "I'll pay it back later, nobody will miss it".

This is a huge factor of the fraud triangle, as it is essentially how people that any rational person would not suspect of fraud reasons in their head that they should go through with the malicious act. Without rationalization, people will be much more likely to realize the harmful impacts of committing fraud, and steer away from pursuing that course of action (Dorminey et al., 2012).

C) Impacts of Fraud in the Business World

Fraud is very costly, both quantitatively and qualitatively. In terms of dollars, fraud losses were estimated to be over 4 trillion US dollars globally in 2018 (Association of Certified Fraud Examiners, 2018). However, even though these dollar amounts are enough to warrant a need to fix this pertinent issue, there are other costs associated with fraud.

Another usually unspoken cost of fraud is the damage to a company's reputation. When an individual commits fraud within the company, it generates a lot of bad press, thus tarnishing that company's name in the mainstream's point of view. According to the Association of Certified Fraud Examiners' (ACFE) latest Report to the Nations, in companies in which fraud was committed, the possibility of bad publicity was the leading reason why those companies did not want to prosecute or expose any fraudulent behavior to the public eye (2 Association of Certified Fraud Examiners, 2018). This is because bad publicity can lead to a reduction in the amount of revenues due to a loss of trust in the entity's customer base, causing them potentially switch to a competing entity.

Taking the full costs of fraud into consideration, it is easy to see that there needs to be a fix to this problem in the business environment.

II THE IMPORTANCE OF INTERNAL CONTROLS

In most work environments today, some form of internal controls exist. Internal controls are defined as, “the mechanisms, rules, and procedures implemented by a company to ensure the integrity of financial and accounting information, promote accountability and prevent fraud” (Kenton, 2019). In 1985, a group of accounting and finance institutions came together to form The Committee of Sponsoring Organizations (COSO). This group developed a framework for internal controls that is widely used in public companies today, and is considered to be an effective method for developing a system of internal controls.

A) The COSO Framework

The COSO Framework lays five key components of internal controls, and why they are important. These five components are: control environment, risk assessment, control activities, monitoring, and information and communication (COSO, 1992). Each of these categories needs to be in place if a strong system of internal controls is to be built.

1) Control Environment

The control environment is the tone in which management of a firm is setting for the operations in the workplace. If the firm has a work environment that does not punish fraud, this will lead to a much greater risk of fraud, as there may seem to be no consequence to unethical behavior. The control environment may be the most important of the five components, as it sets the bar for the rest of the framework.

2) Risk Assessment

Risk assessment relates to how the management of a firm assesses risks of the current internal control structure and making improvements to any outdated, inefficient, or ineffective control items as needed.

3) Control Activities

The control activities are any physical controls used in the workplace. These are things like segregation of duties among staff to keep the roles of custody, recording, reconciliation, and authorization over any workplace items separate. Control activities are usually focused on eliminating the opportunity piece of the fraud triangle.

4) Monitoring

The monitoring part of the framework refers to management's responsibility to monitor the effects of the internal control framework in action.

Monitoring is not simply the routine overview of operations that management normally performs, but rather separate evaluations of internal controls. If any deficiencies are noted, they must be acted on immediately.

5) Information and Communication

The final piece of the framework, information and communication, refers to the quality of information regarding internal controls within the firm, and how this information is communicated throughout the organization. The more understanding the workforce has on the internal controls in place, the more effective those internal controls can be.

B) Constructing an Ethical Control Environment

Now that we have identified the five COSO components of internal controls, we can hone in on the starting point for developing a sound system of internal controls; the control environment. There have been many studies on the effects of the control environment portion of the COSO framework in relation to the risks of fraud in the workplace. With each of these studies, it has been shown that the control environment is easily the most important part of the framework, but cannot be the only part that a company implements (Singleton; King; Messina; Turpen, 2003). For fraud risks to be reduced as effectively as possible, the creation of an ethical control environment must be done in a way that encompasses all parts of the entity, and is maintained by management so as to continue promoting ethical behavior from the employees within the environment.

1) Starting with Management

In a study by Philip Law, it was shown that the people who lead in the workplace and direct individuals in the day to day operations have the most impact on setting the tone at the top (Law, 2011). Therefore its management's responsibility to ensure that the employees understand the entity's commitment to integrity and ethical behavior. For management to communicate this effectively, proper selection of who will be in the management positions must be exercised. By hiring individuals who care about the company's beliefs and goals and who are able to be moral leaders, the entity will be able to maximize the effectiveness of the creation of an ethical control environment (Ocansey and Ganu, 2017).

2) Implementation of Employee-Friendly Policies

Employees are also a large part of the creation of an ethical control environment, as they do the day to day work of the entity. Management must therefore ensure that the employees are well taken care of. One effective way to this is through implementation of employee friendly policies and procedures that allow for employee growth and advancement within the entity. These include things like fair compensation for work performed, alternative benefit plans and amenities at the organization for the use of the employees.

In 2016, a study was conducted by Jun Guo, Pingshun Huang, Yan Zhang, and Nan Zhou in which they tested their theory that better quality employee-friendly policies led to higher employee engagement and reduced the risks for material weaknesses in internal controls. In their results, that stated that, "Our refined tests verify that fair employee treatment effectively prevents material weaknesses [in internal controls] linked to the labor force" (Guo; Huang; Zhang; Zhou, 2016, pg. 1190). This points to the fact that there is a direct link between management's implementation of employee-friendly policies and the employee's job satisfaction and engagement, therefore making employee-friendly policies vital to the development of the control environment.

3) Employee Engagement through Management's Philosophy

Another important part of building a control environment is management's philosophy and operating style, as this plays into employee engagement within the entity. According to research done by Madeline Domino, Stephen Wingreen and James Blanton, an employee's job satisfaction and locus of control are key to keeping them engaged and enjoying what they do in the workplace, thus reducing the effects of pressure and rationalization. In their article, they define locus of control as an employee's sense of their control over rewards and reinforcement they receive (Domino; Flemming; Kranacher, 2014).

If management desires to construct an ethical control environment, they must allow their employees to feel in control of their work. This translates to less micro management, and more trust and respect shown to employees by management. In Ampofo, Mujtaba, and Cavico's (2004) study on organizational culture and ethical decision making, he found that around 41% of the accountants he interviewed stated they did not feel in control of whether or not to post a specific journal entry, even though the majority of the individuals interviewed had over 10 years of accounting experience (Ampofo; Mujtaba; Cavico, 2004). This shows that there may be an issue with accountants lacking the empowerment to make choices in their work, leading them to be less involved in their work, and increasing the forces of pressure and rationalization. Management that goes out of their way to ensure that employees feel involved in their work aid in constructing an ethical control environment in the workplace.

Another important factor in management's philosophy and operating style is how they set goals for the entity. If management is constantly setting goals that seem unattainable to the employees under them, job satisfaction decreases sharply, and those employees are much more likely to misstate financial information in order to have the appearance of meeting the set goals (Ji; Rozenbaum; Welch, 2017). In order to prevent this from happening, management should set reasonable goals, or even let the employees they govern have a say in the goals that are set.

This will motivate both the management team and the employees to work together, thus engaging both in the workplace and reducing the effects of pressure and rationalization.

4) Fraud Awareness and Whistleblowing Rewards

A final part of creating an ethical control environment is through ensuring that the individuals within the environment are aware of fraud and the forms that they come in. This involves communication in throughout the entity by management in which employees are educated on what fraud is and the right actions to take when it occurs in the workplace, those actions being whistleblowing. The act of whistleblowing has been defined as, “the disclosure by organization members (former or current) of illegal, immoral or illegitimate practices under the control of their employers, to persons or organizations that may be able to effect action” (Near and Miceli 1995, p. 4). By encouraging this type of reaction to fraud, the entity will begin to visibly show their commitment to integrity and ethical values. The best way to encourage whistleblowing within an entity is by not only ensuring the protection of the whistleblower, but also going one step further and rewarding them for shining a light on any illegal acts that are being conducted in the workplace (Ocansey and Ganu, 2017).

C) Weaknesses of Overreliance on the Control Environment

Even though the creation of an ethical control environment is the most important part of creating a fraud risk reducing system of internal controls, it cannot be the only part of the COSO framework that is used (Singleton et al, 2003). This is because the creation of an ethical environment specifically attacks the pressure and rationalization parts of the fraud triangle without necessarily addressing the factor of opportunity. In order to make the most of management's efforts in reducing fraud, the control environment must go hand in hand with other COSO components.

1) Control Activities

The control activities portion of the framework includes important internal control concepts to implement into an entity such as segregation of duties. The act of segregating responsibilities amongst employees so that no one employee has more than one role that is incompatible with another specifically targets opportunity within the entity to commit fraud. Roles that are incompatible include authorization, reconciliation, recording and custody. In order to fully implement the control environment in an ethical way, the entity must include proper control activities such as segregation of duties amongst its workforce (Singleton et al, 2003).

2) Risk Assessment and Monitoring

In order to maintain the ethical control environment, the entity should ensure that internal risk assessment and monitoring are being conducted. This means that the entity and its management are evaluating the effects that the control environment and control activities are having on its employees and adjusting accordingly. It also includes assessing the likelihood of internal control systems failing and steps to be taken to reduce that effect. This could include realizing that some sort of control activity has been rendered obsolete and replacing it with a more effective activity. The risk assessment and monitoring parts of the COSO framework are important in effectively maintaining the ethical control environment after its creation.

3) Information and Communication to Employees

One last factor in ensuring that the control environment has been properly implemented is the COSO component of information and communication. If the entity's commitment to integrity and ethical values are to be held among its workforce, they must be communicated with clarity and emphasis by management (Ocansey and Ganu, 2017).

III THE EFFECTIVENESS OF AN IDEAL ETHICAL ENVIRONMENT

After going through the importance of the control environment, I developed a model through the research obtained on how an ideal ethical control environment affects the fraud triangle. It begins with building ethical management, who then communicate the entities desires to maintain integrity and ethical values to the employees, thus removing the pressure portion of the fraud triangle. Through ethical management comes employee satisfaction and locus of control, leading to employees who are engaged in their work which removes the rationalization piece of the fraud triangle. Finally, control activities must be effectively implemented within the firm to ensure that the opportunity portion of the fraud triangle is eliminated. When putting together ethical management, employees that are engaged in their work, and various control activities such as segregation of duties, the fraud triangle is essentially dismantled (see Appendix A). This significantly reduces the risks of fraud in the workplace as I have previously mentioned.

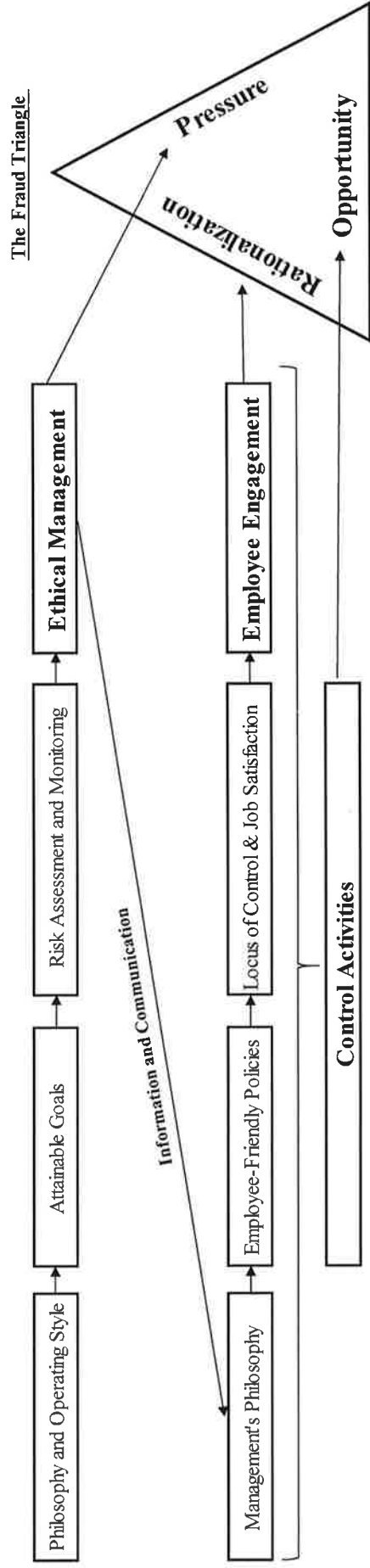
CONCLUSION

Fraud in the workplace is much more prevalent than most people realize, and is extremely costly when it happens. The cause of these fraudulent acts stems from the fraud triangle, which is pressure, opportunity, and rationalization. To reduce the risks of fraud occurring, management of a firm must eliminate one or more of the pillars of the fraud triangle. Building a system of internal controls allows management to accomplish this goal, and the best way to create a quality system of internal controls is by starting from the control environment and working your way down.

By starting with the construction of an ethical workplace, the control environment will be grounded in policies and procedures implemented by management that build employees up and get them engaged in their work. This in turn reduces the risks of fraud, as the pressure and rationalization portions of the fraud triangle will be eliminated. Once the firm accomplishes establishing and maintaining an ethical environment, they can pair this with proper segregation of duties and other controls to further remove the opportunity portion of the fraud triangle. Fraud will never be completely eliminated, but by creating an ethical environment in the workplace and through the implementation of other controls, fraud risks can be substantially reduced to a much more acceptable level.

Appendix A

The Ideal Ethical Control Environment



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